

4.7 The role of international debt

Learning Outcomes

- Outline the meaning of foreign debt and explain why countries borrow from foreign creditors.
- Explain that in some cases countries have become heavily indebted, requiring rescheduling of the debt payments and/or conditional assistance from international organizations, including the IMF and the World Bank.
- Explain why the servicing of international debt causes balance of payments problems and has an opportunity cost in terms of **forgone** spending on development objectives.
- Explain that the burden of debt has led to pressure to cancel the debt of heavily indebted countries.

Synonyms

forgone .. sacrificed/given up

Subject vocabulary

interest the price paid for the use of borrowed money/ the money earned from bank deposits

current account deficit occurs when the amount of money flowing out of a country from the trade in goods and services, investment income, and transfers is greater than the amount flowing in

foreign direct investment cross-border investment, usually by firms, that involves the acquisition of assets in a foreign country. FDI can be the purchase of a minimum of 10% of the shares of a foreign company but also includes the creation of productive capacity.

primary goods a good that has not been processed and is in a raw state (e.g. fruit/wheat)

consumer goods goods that are ultimately consumed by households rather than goods used by firms in the production of another good

capital (goods) manufactured goods that are used in the production of other goods

physical capital any manufactured good that is used in the production of other goods and services such as machinery and buildings

productivity the quantity of output per unit of input

recessions two consecutive quarters of negative economic growth

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Glossary

persistent continues to exist/ happen for a long time

What is foreign debt?

International or external debt is the total amount of money that has been borrowed from foreign financial institutions, such as the World Bank and foreign commercial banks, and foreign governments that has not been repaid. International debt includes the total amount of **interest** that must be paid on the money borrowed.

The reasons why a country must borrow from foreign creditors are discussed below. The main reason a country borrows is because it has a **persistent current account deficit**. Therefore it is important to examine the causes of a current account deficit. (See pages 227–30 for a detailed explanation of the balance of payments.)

What are the causes of international debt?

A persistent current account deficit must be financed by flows of money onto the capital account. The flow of money on to the capital account comes from inward investment, such as **foreign direct investment** and borrowing from other countries.

Model sentence: A country borrows from foreign creditors in order to pay for the deficit on the current account.

Why do countries have persistent current account deficits?

Some of the causes of a current account deficit in LDCs are discussed below.

Why does over-dependence on primary goods worsen the current account deficit?

LDCs are over-dependent on export revenue from **primary goods** and the import of manufactured **consumer goods** and **capital** goods. The long-term price of primary goods is falling therefore export revenue falls over time leading to a worsening of the current account deficit.

Why does using borrowed money to finance current consumption worsen the current account deficit?

LDCs use much of the flows of money onto the capital account, including borrowed money, to buy imported consumer goods to satisfy current needs and wants. It is not all used to invest in **physical capital** and therefore foreign borrowing does not lead to an increase in the future level of **productivity** of the economy. Increases in productivity would lead to an increase in export revenue that is needed to pay back debt. Using borrowed money to finance current expenditure does nothing to help the country earn more income in the future to pay back the debt and the interest on the debt.

Why does economic growth abroad affect the current account deficit?

During global **recessions** and economic downturns, world income and consumption falls, including consumption of goods produced for export in developing countries. This leads to a fall in export revenues of developing countries and an increase in the current account deficit

Why does the price of oil affect the current account deficit and the level of indebtedness?

Some LDCs are dependent on oil for **industrialization**. The price of oil fluctuates. When the price of oil is high more export revenue is needed to buy the oil, thereby worsening the current account deficit and increasing the amount of money LDCs have to borrow. An LDC could choose to reduce the consumption of oil but this would restrict industrialization and slow the **rate of economic growth**. When oil prices are high oil producers

deposit the high profits in financial institutions which then have more money to lend. Some of which is lent to developing countries. When financial institutions have lots of money available for lending, and there are countries wanting to borrow, international debt can get out of control.

Some of the consequences of high levels of indebtedness are discussed below.

The large debts of LDCs are repaid over time from current income, leaving less income available for much needed **investment**. Debt therefore restricts industrialization and economic growth leaving LDCs dependent on the production of primary goods. The countries are unable to break free from the **poverty cycle**.

When an LDC finds it difficult to repay debt it increases the risk of non-debt repayment, therefore lenders charge a higher rate of interest on new debt to compensate for the greater risk and sometimes foreign financial institutions will refuse to lend money because it is too risky. Higher interest rates increase the burden of debt, making it more difficult for the country to make its repayments, and without the borrowed money the private sector is not able to get loans to invest, thereby restricting economic growth.

Model sentence: There is an opportunity cost of borrowing and increased indebtedness. In order to make the repayments on debt the government must reduce spending on infrastructure, education, and health services, negatively affecting economic growth and development.

Explain the causes of the debt crisis during the 1980s and 1990s

Large quantities of debt in US dollars were built up by developing countries in the 1970s and 1980s. In 1982 the Mexican government defaulted on its debt. This means that Mexico stopped paying back its debt. The country did not have enough US dollars to pay back its debt.

Some LDCs were finding it very difficult to repay their loans. The situation was made worse when, in the early 1980s, the price of the US dollar increased. Countries needed more of their own currency to buy dollars in order to repay the loans, while at the same time interest rates increased. Countries borrowed more money in order to be able to pay the additional interest payments. Some existing loans were at variable interest rates. This meant that when the interest rates increased the repayments on existing loans also increased.

In the 1980s and 1990s for some LDCs the debt repayments were greater than the inward flow of money onto the capital account leaving countries unable to invest in new industries, infrastructure, health and educational services. Poor countries became poorer as the effects of high levels of **indebtedness** had a negative impact on economic growth and development.

How might the debt crisis be solved?

Some of the ways in which the debt crisis has been dealt with are discussed below.

What is debt forgiveness?

Much of the debt of LDCs must be paid back to the governments of developed countries, the IMF, and the World Bank. LDCs, and some economists and politicians, argued that the debts should be **written off** or partially written off. If this happened LDCs could use more export revenue to buy more capital goods leading to increases in the rate of industrialization, productivity, and **economic growth**.

However, some economists argued that if debts were forgiven it would provide an incentive for LDCs to borrow greater amounts of money because they would believe that, if necessary, these debts would also be forgiven. This is an example of the **moral hazard** argument. However, some debts of very poor countries were forgiven.

What role does the IMF play in debt rescheduling?

Financial institutions and governments, as an alternative to debt forgiveness, have renegotiated with the LDCs the terms of the repayments of loans. This is called debt rescheduling. For example, the IMF has encouraged lenders to increase the length of time over which LDCs have to make the repayments and to reduce the rate of interest on existing and new loans.

The IMF has offered help to resolve the debt crisis but only if a set of conditions are met by the LDC. These conditions are discussed below.

Devaluation of the currency

A country needs to increase its export revenues and reduce its expenditure on imports in order to have enough foreign currency to pay back its debts. **Devaluation** reduces the price of exports and increases the price of

Subject vocabulary

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industrialization the process in which a country changes its economy from one based primarily on agricultural output into one based on the manufacture of goods

rate of economic growth the percentage increase in a country's output in a given period of time

investment the addition to capital stock

poverty cycle occurs in a country which has low income and therefore low levels of savings. Low levels of savings means little investment can take place and the economy is unable to grow, thus income remains low.

indebtedness occurs when a household, firm, or organization owes money

economic growth an increase in real GDP

moral hazard a situation in which an individual or organization acts knowing that it is protected from the risks of such an action

devaluation the official lowering of the value of a country's currency in a fixed exchange rate system

Glossary

written off cancelled

Subject vocabulary

inflation an increase in the general level of prices of goods/services in an economy over a given time period, usually a year

export revenue income that flows into a country from the rest of the world from the sale of its goods and services to foreign buyers

contractionary (deflationary) fiscal policy policy involving the reduction of government spending and/or the increase of taxation

aggregate demand the total demand for goods and services in the economy at a given price level in a given period of time

disposable income household income after direct taxation has been deducted

trade liberalization the removal of, or reduction in, the international barriers to trade, such as tariffs and quotas

subsidies payments made by government to firms per unit of output

tariffs a tax placed on imported goods and services

privatization the process of transferring the ownership of an enterprise or industry from the public sector to the private sector

deregulation removal of government legislation and laws governing particular markets

capital (goods) manufactured goods that are used in the production of other goods

long-term economic growth an increase in the potential output of an economy

Synonyms

offset..... negating/
counteracting

Glossary

bankrupt stopped trading permanently due to a lack of money

imports. More exports are sold, thereby increasing export revenue and fewer imports are bought reducing the flow of money leaving the country.

Contractionary fiscal policy

Inflation reduces the burden of debt repayments so some countries print money and create **inflation**. There are many costs of inflation discussed in detail on pages 149–51. One of the costs of inflation is a fall in the price competitiveness of exports. Inflation increases the price of exports leading to a fall in demand for exports and a fall in **export revenue**. The country must agree to reducing inflation. **Contractionary (deflationary) fiscal policy** requires increases in taxes and reductions in government expenditure which reduces **aggregate demand** and thereby reduces the rate of inflation. Low inflation increases the competitiveness of exports leading to increases in export revenue. Domestically produced goods also become more price competitive, leading to a fall in demand for imports and a fall in the money flowing out of the country for the purchase of imports.

Increasing taxes and reducing government expenditure may increase the amount of money available to repay debt. Increasing taxes means that the citizens make a greater contribution to the repayment of debt but leaves them less **disposable income** with which to satisfy basic needs. Falls in disposable income and reductions in spending on health and education can lead to a fall in economic development.

Trade liberalization

One of the conditions for loans is **trade liberalization**. LDCs must reduce or remove **subsidies** given to domestic industries and **tariffs** on imported goods. A programme of **privatization** and **deregulation** must also be introduced.

Encouragement of foreign direct investment (FDI)

The advantages and disadvantages of FDI are discussed in detail on pages 267–69.

FDI is an inward flow of money used for the purchase of a country's assets which is recorded on the capital account of the balance of payments. This increase of money flowing into a developing country is a valuable source of foreign currency, allowing for the purchase of a greater quantity of imported consumer goods and **capital** goods as well as the repayment of debt. The IMF believes that FDI promotes **long-term economic growth** thereby reducing the country's dependency on loans in the future.

Why does debt repayment cause balance of payments problems?

(See pages 227–37 for a detailed explanation of the balance of payments and a breakdown of the national accounts.)

A persistent current account deficit occurs when a country continues to spend more income than it is earning. In other words, the country is consuming more than it is producing. In order to do this a country uses its reserves of foreign currency to make up the difference between income spent and income earned. If this is not enough the country must borrow from other countries. Savings used and money borrowed are recorded as a positive on the capital account because they balance out the deficit on the current account.

However, a country cannot **offset** the current account deficit forever. At some point the foreign reserves will run out. The country cannot borrow forever because as debt continues to build up the country will not be able to pay the interest on the debt. The interest on the debt is recorded on the current account as a negative.

Model sentence: *Ceteris paribus*, as interest repayments increase, the current account deficit worsens and the country will need to borrow more money in order to offset the increase in the current account deficit.

An LDC in this situation will not be able to borrow more money because lenders will think that the country will not be able to finance the interest payments on the debt. If this happens the country will be **bankrupt**. When this is likely to occur the IMF can provide assistance by, for example, rescheduling debt.

Test your understanding of this unit by answering the following questions

- Why do developing countries need to borrow from foreign countries?
- Explain why borrowing has an opportunity cost.
- Explain why the current account + the capital account = 0.
- Discuss the causes of high indebtedness in LDCs.